

Example 4. (i) USdrug, a U.S. pharmaceutical company, has developed a new drug, Nosplit, that is useful in treating migraine headaches and produces no significant side effects. Nosplit replaces another drug, Lessplit, that USdrug had previously produced and marketed as a treatment for migraine headaches. A number of other drugs for treating migraine headaches are already on the market, but Nosplit can be expected rapidly to dominate the worldwide market for such treatments and to command a premium price since all other treatments produce side effects. Thus, USdrug projects that extraordinary profits will be derived from Nosplit in the U.S. market and other markets.

(ii) USdrug licenses its newly established European subsidiary, Eurodrug, the rights to produce and market Nosplit in the European market. In setting the royalty rate for this license, USdrug considers the royalty that it established previously when it licensed the right to produce and market Lessplit in the European market to an unrelated European pharmaceutical company. In many respects the two license agreements are closely comparable. The drugs were licensed at the same stage in their development and the agreements conveyed identical rights to the licensees. Moreover, there appear to have been no significant changes in the European market for migraine headache treatments since Lessplit was licensed. However, at the time that Lessplit was licensed there were several other similar drugs already on the market to which Lessplit was not in all cases superior. Consequently, the projected and actual Lessplit profits were substantially less than the projected Nosplit profits. Thus, USdrug concludes that the profit potential of Lessplit is not similar to the profit potential of Nosplit, and the Lessplit license agreement consequently is not a comparable uncontrolled transaction for purposes of this paragraph (c) in spite of the other indicia of comparability between the two intangibles.

(d) *Unspecified methods—(1) In general.* Methods not specified in paragraphs (a)(1), (2), and (3) of this section may be used to evaluate whether the amount charged in a controlled transaction is arm's length. Any method used under this paragraph (d) must be applied in accordance with the provisions of § 1.482-1. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. For exam-

ple, the comparable uncontrolled transaction method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price the parties would have agreed to had they resorted directly to a market alternative to the controlled transaction. Therefore, in establishing whether a controlled transaction achieved an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction. As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See § 1.482-1(c). Therefore, in accordance with § 1.482-1(d) (Comparability), to the extent that a method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

(2) *Example.* The following example illustrates an application of the principle of this paragraph (d).

Example. (i) USbond is a U.S. company that licenses to its foreign subsidiary, Eurobond, a proprietary process that permits the manufacture of Longbond, a long-lasting industrial adhesive, at a substantially lower cost than otherwise would be possible. Using the proprietary process, Eurobond manufactures Longbond and sells it to related and unrelated parties for the market price of \$550 per ton. Under the terms of the license agreement, Eurobond pays USbond a royalty of \$100 per ton of Longbond sold. USbond also manufactures and markets Longbond in the United States.

(ii) In evaluating whether the consideration paid for the transfer of the proprietary process to Eurobond was arm's length, the district director may consider, subject to the best method rule of § 1.482-1(c), USbond's alternative of producing and selling Longbond itself. Reasonably reliable estimates indicate that if USbond directly supplied Longbond to the European market, a selling price of \$300 per ton would cover its costs and provide a reasonable profit for its functions, risks and investment of capital associated with the production of Longbond for the European market. Given that the market price of Longbond was \$550 per ton, by licensing the

proprietary process to Eurobond, USbond forgoes \$250 per ton of profit over the profit that would be necessary to compensate it for the functions, risks and investment involved in supplying Longbond to the European market itself. Based on these facts, the district director concludes that a royalty of \$100 for the proprietary process is not arm's length.

(e) *Coordination with tangible property rules.* See § 1.482-3(f) for the provisions regarding the coordination between the tangible property and intangible property rules.

(f) *Special rules for transfers of intangible property—*(1) *Form of consideration.* If a transferee of an intangible pays nominal or no consideration and the transferor has retained a substantial interest in the property, the arm's length consideration shall be in the form of a royalty, unless a different form is demonstrably more appropriate.

(2) *Periodic adjustments—*(i) *General rule.* If an intangible is transferred under an arrangement that covers more than one year, the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible. Adjustments made pursuant to this paragraph (f)(2) shall be consistent with the arm's length standard and the provisions of § 1.482-1. In determining whether to make such adjustments in the taxable year under examination, the district director may consider all relevant facts and circumstances throughout the period the intangible is used. The determination in an earlier year that the amount charged for an intangible was an arm's length amount will not preclude the district director in a subsequent taxable year from making an adjustment to the amount charged for the intangible in the subsequent year. A periodic adjustment under the commensurate with income requirement of section 482 may be made in a subsequent taxable year without regard to whether the taxable year of the original transfer remains open for statute of limitation purposes. For exceptions to this rule see paragraph (f)(2)(ii) of this section.

(ii) *Exceptions—*(A) *Transactions involving the same intangible.* If the same intangible was transferred to an uncontrolled taxpayer under substantially

the same circumstances as those of the controlled transaction; this transaction serves as the basis for the application of the comparable uncontrolled transaction method in the first taxable year in which substantial periodic consideration was required to be paid; and the amount paid in that year was an arm's length amount, then no allocation in a subsequent year will be made under paragraph (f)(2)(i) of this paragraph for a controlled transfer of intangible property.

(B) *Transactions involving comparable intangible.* If the arm's length result is derived from the application of the comparable uncontrolled transaction method based on the transfer of a comparable intangible under comparable circumstances to those of the controlled transaction, no allocation will be made under paragraph (f)(2)(i) of this section if each of the following facts is established—

(1) The controlled taxpayers entered into a written agreement (controlled agreement) that provided for an amount of consideration with respect to each taxable year subject to such agreement, such consideration was an arm's length amount for the first taxable year in which substantial periodic consideration was required to be paid under the agreement, and such agreement remained in effect for the taxable year under review;

(2) There is a written agreement setting forth the terms of the comparable uncontrolled transaction relied upon to establish the arm's length consideration (uncontrolled agreement), which contains no provisions that would permit any change to the amount of consideration, a renegotiation, or a termination of the agreement, in circumstances comparable to those of the controlled transaction in the taxable year under review (or that contains provisions permitting only specified, non-contingent, periodic changes to the amount of consideration);

(3) The controlled agreement is substantially similar to the uncontrolled agreement, with respect to the time period for which it is effective and the provisions described in paragraph (f)(2)(ii)(B)(2) of this section;

(4) The controlled agreement limits use of the intangible to a specified field

or purpose in a manner that is consistent with industry practice and any such limitation in the uncontrolled agreement;

(5) There were no substantial changes in the functions performed by the controlled transferee after the controlled agreement was executed, except changes required by events that were not foreseeable; and

(6) The aggregate profits actually earned or the aggregate cost savings actually realized by the controlled taxpayer from the exploitation of the intangible in the year under examination, and all past years, are not less than 80% nor more than 120% of the prospective profits or cost savings that were foreseeable when the comparability of the uncontrolled agreement was established under paragraph (c)(2) of this section.

(C) *Methods other than comparable uncontrolled transaction.* If the arm's length amount was determined under any method other than the comparable uncontrolled transaction method, no allocation will be made under paragraph (f)(2)(i) of this section if each of the following facts is established—

(1) The controlled taxpayers entered into a written agreement (controlled agreement) that provided for an amount of consideration with respect to each taxable year subject to such agreement, and such agreement remained in effect for the taxable year under review;

(2) The consideration called for in the controlled agreement was an arm's length amount for the first taxable year in which substantial periodic consideration was required to be paid, and relevant supporting documentation was prepared contemporaneously with the execution of the controlled agreement;

(3) There have been no substantial changes in the functions performed by the transferee since the controlled agreement was executed, except changes required by events that were not foreseeable; and

(4) The total profits actually earned or the total cost savings realized by the controlled transferee from the exploitation of the intangible in the year under examination, and all past years, are not less than 80% nor more than

120% of the prospective profits or cost savings that were foreseeable when the controlled agreement was entered into.

(D) *Extraordinary events.* No allocation will be made under paragraph (f)(2)(i) of this section if the following requirements are met—

(1) Due to extraordinary events that were beyond the control of the controlled taxpayers and that could not reasonably have been anticipated at the time the controlled agreement was entered into, the aggregate actual profits or aggregate cost savings realized by the taxpayer are less than 80% or more than 120% of the prospective profits or cost savings; and

(2) All of the requirements of paragraph (f)(2)(ii) (B) or (C) of this section are otherwise satisfied.

(E) *Five-year period.* If the requirements of § 1.482-4 (f)(2)(ii)(B) or (f)(2)(ii)(C) are met for each year of the five-year period beginning with the first year in which substantial periodic consideration was required to be paid, then no periodic adjustment will be made under paragraph (f)(2)(i) of this section in any subsequent year.

(iii) *Examples.* The following examples illustrate this paragraph (f)(2).

Example 1. (i) USdrug, a U.S. pharmaceutical company, has developed a new drug, Nosplit, that is useful in treating migraine headaches and produces no significant side effects. A number of other drugs for treating migraine headaches are already on the market, but Nosplit can be expected rapidly to dominate the worldwide market for such treatments and to command a premium price since all other treatments produce side effects. Thus, USdrug projects that extraordinary profits will be derived from Nosplit in the U.S. and European markets.

(ii) USdrug licenses its newly established European subsidiary, Eurodrug, the rights to produce and market Nosplit for the European market for 5 years. In setting the royalty rate for this license, USdrug makes projections of the annual sales revenue and the annual profits to be derived from the exploitation of Nosplit by Eurodrug. Based on the projections, a royalty rate of 3.9% is established for the term of the license.

(iii) In Year 1, USdrug evaluates the royalty rate it received from Eurodrug. Given the high profit potential of Nosplit, USdrug is unable to locate any uncontrolled transactions dealing with licenses of comparable intangible property. USdrug therefore determines that the comparable uncontrolled